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Development in Islamic Debt Securities: Establishing Malaysia as an International Islamic Capital Market Centre

Mukaramah Harun, Siti Hadijah Che Mat and Noor Sa'adah Sabudin
Universiti Utara Malaysia

Introduction

The Islamic capital market is a niche market in which Malaysia has a comparative and competitive advantage and represents a potentially significant area where Malaysia can effectively position itself at the global forefront. Malaysia has seen significant development and expansion in the Islamic equity and bond markets over recent years. The nation has also earned a reputation as one of the pioneers in Islamic capital market-related research and development.

There is a large untapped potential for development in Islamic capital markets internationally as well as domestically. In the international market, there are massive Islamic funds that are looking for Islamic instruments from the Islamic countries. Funds from the Middle East are looking for new investment opportunities after an exodus from the US after September 1997 and Britain after July 2005 (bombing in London). Islamic investment is expected to expand at a rate of between 12% and 15% per annum over the coming years.

In the domestic market, Malaysia has large local funds available for investment particularly from institutional investors such as Employees Provident Fund (EPF), Lembaga Tabung Haji, Permodalan Nasional Berhad and Lembaga Tabung Angkatan Tentera. Other investors include banking institutions, insurance companies, asset management companies and money brokers. All of them are always looking for investment opportunities. Presently, suitable instruments have not emerged quickly enough to absorb this huge investible fund. The largely untapped demand for Islamic financial products, both international and domestic, presents a valuable opportunity for Malaysia to establish itself as a hub for the Islamic capital market.

Hence, Malaysia in its Capital Market Masterplan 2001 aims to turn the country into an international Islamic capital market centre. The aim reflects a overarching aspiration that is intended to drive the development and strategic positioning of the Islamic capital market, and lay a strong foundation for further growth thereafter. There are four main strategic initiatives that have been identified to achieve this objective. These strategic initiatives are: first, facilitate the development of a wide range of competitive products and services related to the Islamic capital market; second, create a viable market for the effective mobilisation of funds; third, ensure that there is an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market and four enhance the value recognition of the Malaysian Islamic capital market internationally.

This paper will address the development of the Islamic capital market in Malaysia with the focus on Islamic debt securities market as a means to achieve the objective of establishing Malaysia as an international Islamic capital market centre. The discussion on development of the Islamic capital market will be closely linked to the four strategic initiatives that form the basis for the Masterplan to realise the objective.

Islamic Debt Securities Development

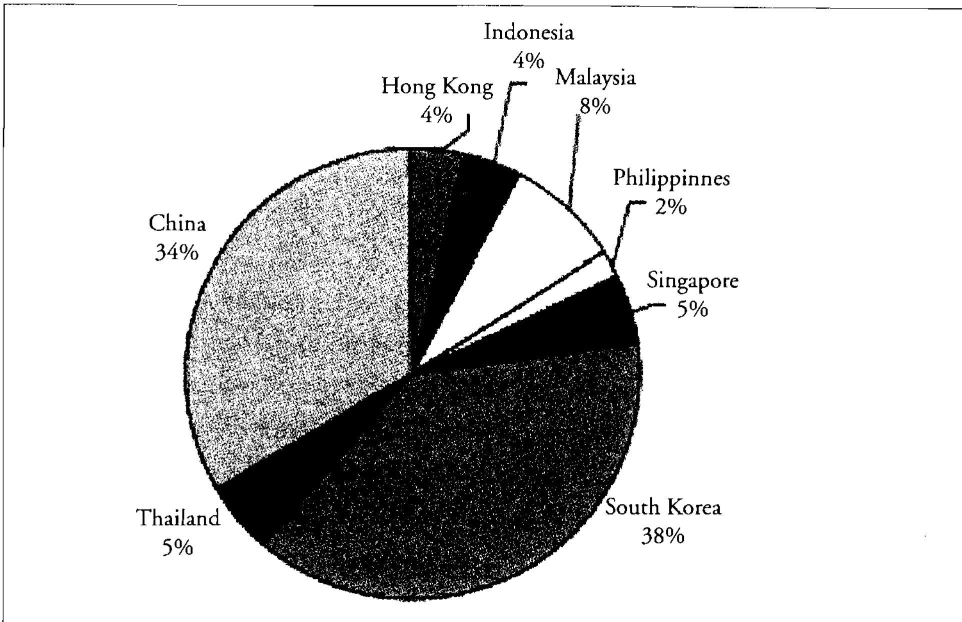
Malaysia has emerged as one of the most developed markets in debt securities. Despite a small domestic market, Malaysia has the biggest bond market in size relative to the Gross Domestic product (GDP) among Asian nations. In Table 1, outstanding Ringgit bonds grew by 10.7% to RM363 billion in 2004, accounting for 81% of GDP, followed by South Korea at 72% and Singapore at 56%. Based on Figure 1, Malaysia accounts for 8% of the total size of the Asian bond market, ranking third after South Korea and China. This bond market share is the highest among South East Asian countries. Thailand and Singapore account for about 5% of the total size of the Asian bond market each respectively.

Table 1: Size of Asian GDP and bond market

Country	Domestic market size (USD bn)	Percentage	Size of bound market/GDP
South Korea	488	38.8%	72.0%
China	442	35.1%	28.0%
Malaysia	96	7.6%	81.0%
Singapore	58	4.6%	56.0%
Thailand	57	4.5%	35.0%
Indonesia	47	3.7%	18.0%
Hong Kong	45	3.5%	27.0%
Philippines	25	2%	29.0%
Total	1258	100.0%	

Source: BIS 2004

The emergence of the modern Islamic financial market in Malaysia has been a relatively recent development compared with the more established conventional financial system. It was only in 1983 that the first Islamic bank, Bank Islam Malaysia, was established to provide financial services according to Islamic principles. Shell MDS Sdn Bhd had issued the first private sector Islamic bond in 1990. Since then, many of the country's largest corporations such as Petronas, Tenaga Nasional and Telekom Malaysia have sought financing and issued long-term corporate debt using Islamic-based



Source: BIS 2004

Figure 1: Size of Asian bond market: USD1.43 trillion

instruments. Despite its relatively nascent emergence, the domestic market for Islamic securities has grown slowly but steadily over the last few years.

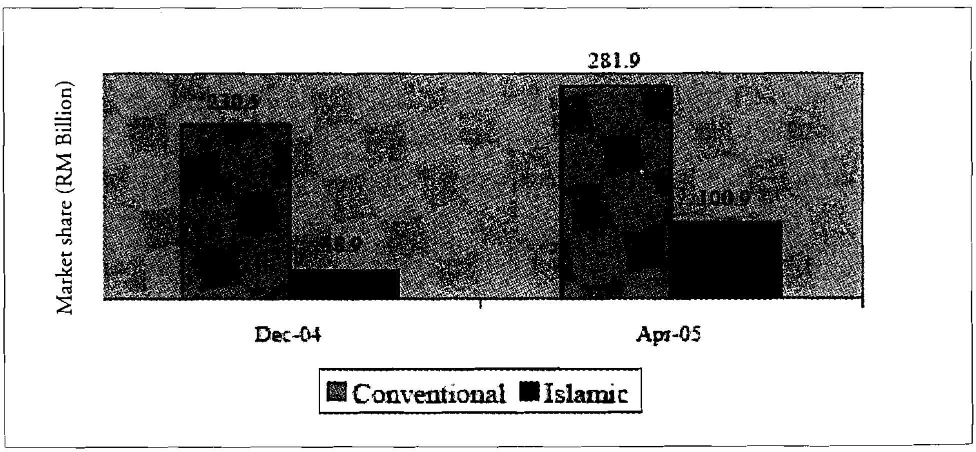
The rise of Malaysia's Islamic securities market took off after efforts by the government to spur Islamic instruments began after Asian currency crisis; followed by the introduction of the Capital Market Masterplan. Table 2 shows the demand for Islamic debt instruments, which accounted for only 7% of total bonds raised in 1999 grew to 25% in 2000 and subsequently to 36% in 2001. There has been a significant growth in issuance over the years due to high demand for Islamic securities, relatively more cost effective for corporate issuers and increasing depth and breadth of the Islamic money market.

Table 2: Funds raised in the capital market

	1996	1997	1998	1999	2000	2001
Value (RM million)	2,350	5,249	345	1,734	7,666	13,028
Islamic bonds	10,034	10,222	10,487	20,399	14,884	17,289
Conventional bonds	12,384	15,471	10,832	22,133	22,550	30,317
Total PDS raised	19	34	3	8	34	43
Proportion (%)						
Islamic bonds						
Conventional bonds						

Source: Bank Negara Malaysia, various years

Figure 2 shows that the total Islamic financial instruments constituted 26% (RM100.9 billion) of the total financial instruments issued (RM382.8 billion) in April 2005 compared to only 14.9% (RM38.9 billion) of the total financial issued (RM269.4 billion) in December 2004. This indicates that Islamic debt securities are growing at a significant rate as well as being competitive compared to conventional instruments.



Source: RAM Bond Newsletter, January 2005

Figure 2: Market share of Islamic instruments vis-avis conventional

Development of Competitive Products & Services

There is a need to develop a variety of Islamic securities instruments in order to build a competitive and attractive Islamic capital market to issuers and investors. The range of products and services available should be adequate to meet investment, capital raising and risk management needs.

Developing a wide range of products and services also entails developing the range and quality of local expertise in Islamic securities. Hence, in 2001, the Islamic Banking and Finance Institute of Malaysia (IBFIM) was launched as an industry-owned research and training institute. IBFIM would function as a centre for providing education, training and research on Islamic financial services, covering Islamic banking, *Takaful* and Islamic capital market at both the domestic and international levels. As part of the initiatives to enhance the effectiveness in disseminating information on Islamic instruments, many national and international conferences were held.

The tremendous increase in demand for Islamic instruments is primarily due to investor awareness of alternative funding sources and the increasing number of Islamic funds launched over the years. In 2001, there were three government funds disbursed under the Islamic concept, namely the New Entrepreneurs Fund 2 (NEF 2), Entrepreneurs Rehabilitation and Development Fund (ERDF) and Fund for Food (3F). This year also saw the introduction of securitisation of Islamic financing. This new instrument will provide additional investment opportunities to market players. Islamic banking institutions are allowed to sell debt arising from financing to Cagamas Berhad, following which, Cagamas will issue Cagamas *Mudarabah* bonds to finance the transaction. In 2004, Cagamas Berhad introduced a new Islamic mortgage security based on the concept of *Bai' Bithamin Ajil.*

A variable rate financing product under the concept of *Bai' Bithamin Ajil* was introduced in 2003 as an instrument to diversify the financing portfolio of the Islamic financial institutions from over reliance on fixed-rate financing as well to mitigate the risks associated with funding mismatch.

Presently, various products are available for those who seek to transact only in Islamic securities, including a list of *Syariah* approved securities, Islamic debt securities, Islamic unit trusts, warrants based on *Syariah*-approved securities, and CPO futures. There are two Islamic equity indices, the KLSE *Syariah* Index and the RHB Islamic Index. In terms of services, the capital market offers Islamic product structuring, project financing, stockbroking and management services. Malaysia has a number of market intermediaries that cater specifically to Islamic capital market investors. There are a number of stockbrokers who operate based on *Syariah* principles and on the asset management side, there are also a few specialized Islamic asset management companies.

No fewer than 40% of all Malaysian domestic bonds are now *Syariah* compliant, especially the larger issues, and this proportion continues to grow. *Syariah* compliant bonds are the instruments of choice for issuers, because they guarantee access to a larger investor base. The result is that Malaysia's Islamic financing landscape has advanced in terms of products and services offered, further adding to the sophistication of the domestic capital market.

The *Al-Bai Bithamin Ajil* (ABBA) structure has been the preferred choice to finance projects with high capital requirements and long gestation periods in the Islamic bond market. Besides ABBA, another popular Islamic bond tool is the *Murabahah* concept, which caters for short to medium-term requirements. Other Islamic concepts available to the market include *Istisna, Ijarah, Mudarabah* and *Musharakah.*

The entry of new foreign Islamic banking players is expected to foster the development of more innovative Islamic financial products and services in the market. In 2004, Bank Negara Malaysia approved three leading foreign Islamic financial institutions from the Middle East, namely Kuwait Finance House, Al-Tajhi Banking & Investment Corporation and a consortium of Islamic Financial Institutions represented by Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House.

Viable Market for Effective Mobilisation of Islamic Funds

The Islamic capital market should be liquid and efficient enough to provide investors, fund managers and Islamic banking with competitive investment avenues that facilitate a more efficient mobilisation of funds. The effective mobilisation of Islamic funds can only be truly realised if those who manage these funds have the ability to invest them in such a manner so as to attain sufficiently diversified portfolios whilst simultaneously strive to maximise their returns. However, the Islamic capital market for all its growth and promise still suffers from certain structural and depth impediments in certain areas.

The main factor attributed to these phenomena is a limited participation of institutions managing Islamic funds in the Islamic capital market. And for those existing institutions that manage the Islamic funds, there is a specific investment restriction imposed on them.

In view of this, stronger measures are needed to facilitate the greater participation of Islamic funds. Liberalisation of the EPF funds is seen as necessary to channel funds to selective fund managers who are involved in managing Islamic funds. The mobilisation of EPF funds can lead to more proactive and efficient management through the engagement of professional Islamic investment managers that in turn will promote the development of the Islamic investment management industry. In addition, the liberalisation of specific investment restrictions on institutions managing Islamic funds such as the *Takaful* industry will allow excess funds within these institutions to be invested based on their own investment mandates and prudential requirements. Efforts to mobilise untapped Islamic assets through securitisation should seriously be pursued. These include allowing the securitization of Islamic assets belonging to Islamic institutions such as *Wakaf* Corporation and *Baitulmal.*

Secondary market trading and a benchmark yield curve are also seen as important to the effective mobilisation of Islamic funds. However, bonds trading in Malaysia remain relatively inactive and there is a lack of a benchmark yield curve. This is particularly due to the captive demand market. Islamic bonds are usually issued through private placement especially if the amount involved is large. As a result, a large portion of the Islamic bonds was allotted to government related institutions such as EPF, Lembaga Tabung Angkatan Tentera and Tabung Haji, which normally hold their bonds until maturity. As these institutions are basically government-related companies, they are expected to accept the offered price of bonds. Therefore, bonds yields have been systematically distorted by the government. This implies that the market yield of most Islamic bonds is below that of the market. The secondary market is adversely affected by these distorted yields. In addition, the issuance through direct placements is likely to be less transparent. In fact they do not do much in terms of promoting investor understanding of securities, and may diminish the ability of investors to trade these bonds.

Appropriate and Comprehensive Tax and Regulatory Framework

To be an Islamic capital market centre for both global and domestic issues, the market should be characterised by a well defined and widely accepted accounting, tax and regulatory framework. Therefore, several initiatives have been taken to facilitate such an environment that meets international standards.

In 1995, the Capital Market Unit was established; comprising experts in *Figh Muamalat* and capital market practices, to undertake research in product origination and Islamic capital market operations. In 1996, the National *Syariah* Advisory Council was established to enhance *Syariah* standards. In 2001, the Malaysian Accounting Standards Board (MASB) issued MASB *i*-1 (presentation of Financial Statements of Islamic Financial Institutions). The objective of the standard is to lay out the basis for the presentation and disclosure of financial statements of Islamic financial institutions that conduct Islamic banking activities. In 2002, The Islamic Financial Services Board (IFSB) worked jointly with the IMF and the Islamic Development Bank (IDB) to standardise regulations and best practices within the Islamic financial industry. In the same year, the International Islamic Financial Market (IIFM) was jointly established by Malaysia and Bahrain with the purpose of facilitating the development of an international Islamic money market. This initiative is also being carried out by LOFSA (Labuan Offshore Financial Services Authority) to promote Labuan as an international Islamic Financial Centre.

As part of its initiative to assist in the development of the Islamic debt market, Bank Negara has announced a new measure related to Islamic debt taxes in the recent budget (2005). Additional tax or duty will be exempted or given specific treatment for the Islamic financial products that are approved by the *Syariah* Advisory Council of Bank Negara Malaysia; and for the Islamic capital market products approved by the *Syariah* Advisory Council of the Securities Commission. The initiative is in line with the government's efforts to promote Islamic financial and capital market products and to ensure tax neutrality with conventional products. Previously, Islamic financial and capital market products were burdened by additional taxes and duties due to additional transactions and instruments being required to comply with *Syariah* principles.

Value Recognition of Malaysian Islamic Capital Market Internationally

To establish Malaysia as a major international Islamic capital market, there have been calls for a bold approach towards raising the international profile and name recognition of the Malaysian Islamic capital market. Malaysia, in spite of the short period of time, has achieved commendable progress in developing its Islamic capital market relative to the present stage of the global Islamic financial market. Compared to many other major Islamic countries such as Bahrain, Oman, Kuwait, Saudi Arabia, Pakistan and Egypt, the bond market in Malaysia is on par with them.

There is also a sign that Malaysia's Islamic bonds are gaining recognition at the international market. As evidence, Malaysia has successfully launched the first sovereign global Islamic *Sukuk* in June 2002. The 5-Year bond valued at USD600 million has received international recognition and also widely

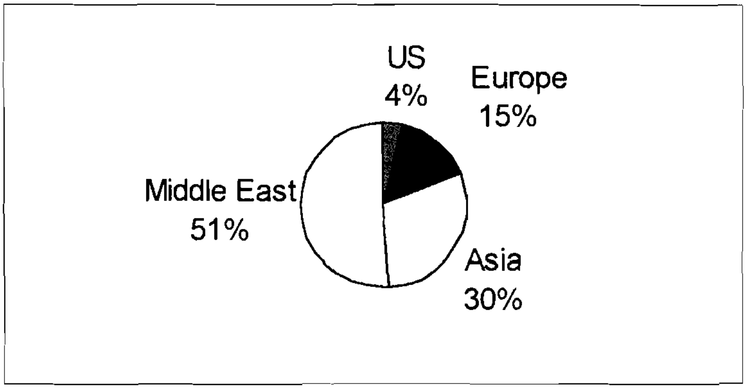


Figure 3: Malaysian Global Islamic Sukuk: Geographical distribution

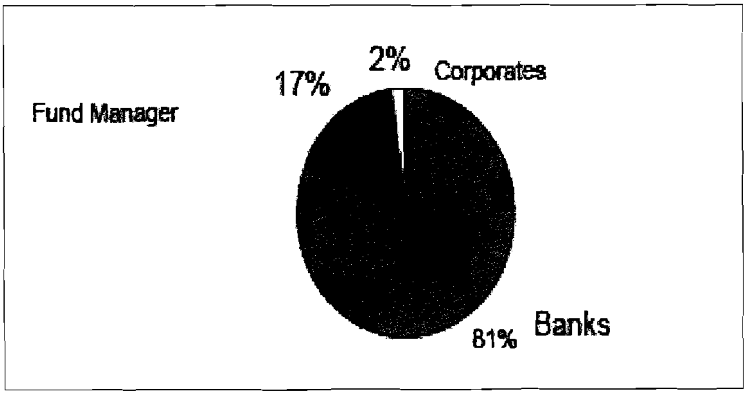


Figure 4: Malaysian Global Islamic Sukuk: Investor distribution

accepted by investors. The bond signified Malaysia's strong commitment to support the development of Islamic bond on the global front. The move to access the international capital market based on Islamic principles was to give impetus to the development of the Islamic financial market, to create a new asset class for investors and to diversify the investor base for Malaysia.

Figure 3 shows that Middle Eastern investors subscribed 51%, followed by Asia (30%), Europe (15%) and US (4%). In terms of investor distribution (Figure 4), banks subscribed 81% of the bonds, followed by fund managers (17%) and corporations (2%). Apart from the listing on the Luxembourg

Stock Exchange, the bond is also listed on the Labuan International Financial Exchange.

Although we achieved some recognition as well as made commendable progress in the Islamic capital market, we have yet to attain the desired recognition on a international level. As reported in the Capital Market Masterplan, an estimated USD800 billion of Islamic capital is presently invested in banks throughout the world.

Conclusion

The significant progress in the growth of Islamic debt securities is a good sign that Malaysia may yet achieve its aim of being an international Islamic capital market centre. It has indicated its readiness to develop an Islamic capital market whose products are accepted locally as well as internationally. The development of Malaysia as an international Islamic capital market is due to the fact that most of the products and services that constitute a market are already in place. The Malaysian market has established a number of competitive products and services as well as established an appropriate accounting, tax and regulatory framework. Nevertheless, we still have not realised a certain level of liquidity in order to create a viable market for the effective mobilisation of Islamic funds. Hence, there is still much to be done in order to develop to the next phase. Among others, improving the institutional framework within which Islamic products and services are delivered, establish a reliable and efficient benchmark yield curve to ensure correct pricing of bonds, widening the issuer and investor base, and minimise the sale of securities through private placement in order to avoid yield distortion.

The right mixture of strong cooperation between regulators, conducive market conditions, and growing awareness to look away from traditional bank loans to alternative forms of fund raising are believed to be some of the key reasons for the the meteoric growth in the Islamic capital market. In addition, strong local and international untapped demand offers good prospects for further development.

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